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Comments by the German Leasing Association (BDL) on the consultative document "Implementing the final Basel III reforms in the EU"

Dear ladies and gentlemen,

thank you very much for the opportunity to comment on the draft paper "Implementing the final Basel III reforms". The German Leasing Association (BDL) represents the interests of the leasing industry in Germany, which, with a new business volume of around EUR 70 billion in 2018, realizes around a quarter of all equipment investments and more than half of all externally financed equipment investments in Germany. The German leasing industry is thus making a substantial contribution to the funding of German SMEs in particular. The German leasing market is the second biggest market in Europe.

General remarks

The term "leasing" is not uniformly defined in the CRR either, which is why the term also covers significantly different business models in the various European countries. Furthermore, leasing companies in Europe are subject to different regulatory standards, ranging from largely unregulated regimes to bank-like regulation. Leasing companies in Germany do not fall within the scope of the CRR, but are subject to strict national supervision, so that leasing companies are classified as comparably robustly regulated compared to banks ("CRR-institutes").

Even though leasing companies in Germany are not CRR-institutes, leasing companies are directly or indirectly affected by the Basel III reforms. Leasing companies that are operated as a bank or fall within a bank's scope of regulatory consolidation are directly affected. By contrast, independent leasing companies in Germany are indirectly affected if they fund their leasing business by banks. All leasing companies are thus affected by the Basel III reforms, although they are not among the primary addressees of the Basel III reforms.

The Basel III reforms are a reaction to the financial crisis since 2008, which had its origin in the difficulties of individual banks, then extended to the entire banking sector and finally had an impact on the real economy. In the course of this, leasing companies in Germany also suffered as demand in the real economy declined and funding via banks became a bottleneck for new business. Nevertheless, no leasing company had to face similar problems as many banks. Leasing companies were therefore not the cause of the financial crisis but were themselves affected. Moreover, the investment activities of leasing companies had a stabilizing effect and made a significant contribution to the recovery of the real economy in Germany.

Since most leasing companies depend on external funding from banks, leasing companies have a vital interest in a stable financial system. BDL therefore supports measures that increase the stability of the financial system. Following the causes of the financial crisis, the Basel III reforms aim to stabilize mainly large, internationally active banks. However, leasing companies are also directly or indirectly affected by the reforms, although their business model differs significantly from that of a major bank. With regard to the principle of proportionality, which is also aimed for in the Basel III reforms, the following differences should be highlighted:

- The majority of leasing companies in Germany have less than 50 employees and a balance sheet total of less than EUR 500 million and are therefore to be assigned to the SME sector, just like most of their customers. In line with their size and business model, the organizational structures of leasing companies are not very complex.

- The leasing business is extremely low-risk, as leasing companies actively limit their risk through their asset and remarketing competence and the ownership position of the lessor. Funding is largely handled with matching maturities and conducted via fully supervised credit institutes. Furthermore, Leasing companies are not entitled to engage in deposit business, which requires special protection.

- Despite their small size and complexity and their low-risk business model, leasing companies in Germany are subject to prudential standards and a level of supervision equivalent to those applied to banks. The EBA also does not see any need for additional regulation.

The incongruity between the primary addressees of the Basel III reforms and the group of those actually affected causes collateral damage that cannot be reconciled with the principle of proportionality to which the Basel reforms are also committed. Furthermore, the principle of subsidiarity is also violated if nationally influenced business models such as leasing are forced into a framework that is not adequately differentiated. This threatens to cause lasting damage to the leasing business model and jeopardizes the funding of small and medium-sized enterprises in Germany.

Credit risk

The greatest threat comes from inappropriately high capital requirements for credit risks in leasing under Basel III, since the actual default risks in leasing are significantly lower than in the lending business due to the asset and remarketing competence and the ownership position of the lessor. This results in misallocations that systematically discriminate leasing from lending business and can lead to restrictions on investment activity, especially in the case of small and medium-sized companies.

The systematic discrimination between leasing and lending business can already be demonstrated for the current regulatory framework and will be further intensified by the transition to Basel III. The low risk in leasing compared to the lending business and the associated systematic discrimination against the lending business are impressively confirmed by empirical studies by the University of Cologne. The studies, which are based on a dataset of detailed contract-level information by twelve major European leasing companies operating across 25 countries, show the adequate calibration for leasing exposures compared to its real risk profile (based on the current CRR).

Table 1 below presents the main results of the study. For all three regulatory credit risk approaches, regulatory requirements are much higher than the unexpected losses in a simulation of a downturn. Regulatory capital in all of the three approaches is in every year too high for the case of leasing. As expected, the Standardized Approach (SA) yields the highest capital requirements and will therefore lead to the highest deviation from the “true” risk level. However even the A-IRB approach with the lowest regulatory requirements will lead to an equity backing which is almost five times higher than the unexpected losses in the simulation.

	2007	2008	2009	2010	2011	Total
SA	8.17%	7.97%	8.33%	8.44%	8.50%	8.31%
F-IRB	5.34%	5.46%	5.96%	5.98%	5.95%	5.80%
A-IRB	4.19%	4.76%	5.61%	5.69%	5.36%	5.25%
Unexpected loss	1.03%	1.45%	1.29%	0.65%	0.52%	1.09%

Table 1: Comparison of regulatory requirements and unexpected losses split by years

The results presented in Table 1 confirm that leasing should have a differentiated prudential treatment as its business model and risks are significantly differ from other types of lending.

In order to develop such a differentiated supervisory treatment, two different directions of development must be considered, because leasing companies can be affected in two different ways: **(1)** - the indirect path, if the leasing company acts as borrower and funding is gained via a CRR-institute. **(2)** - the direct path, if the leasing company acts as a CRR institute or falls within the scope of consolidation of a CRR institute.

(1) The majority of leasing companies in Germany follow the first path and are indirectly affected. The majority of these leasing companies in Germany usually obtain their funding with matching maturities via CRR-institutes, whereby the large credit institutes tend to use advanced approaches and the smaller credit institutes tend to use standard approaches. Since standard approaches (may) determine the results of the advanced approaches via the output floor, the standard approaches are of particular importance for leasing-companies in Germany.

The External Credit Risk Assessment (ERCA) approach is intended to determine risk weights depending on external credit ratings. In contrast, the Standardized Credit Risk Assessment (SCRA) approach is to be applied to risk positions of institutes without external credit assessments. Due to the specific economic structure in Germany with many small and medium-sized companies, the vast majority of leasing companies do not have an external rating, so that the SCRA must be applied to these institutes.

The creditworthiness of receivables from leasing companies is assessed in the SCRA on the basis of quantitative and qualitative criteria that lead to a classification in one of the three credit rating classes A/B/C. However, the quantitative criteria are not applicable to receivables from leasing companies in Germany, as the majority of leasing companies are not subject to the capital adequacy requirements under the CRR. Receivables from leasing companies can therefore be classified solely on the basis of the qualitative criteria.

The requirements resulting from the qualitative criteria for classification in credit rating class A are subject to strict audit and supervision in Germany, which are determined by the "Minimum Requirements for Risk Management". If leasing companies meet these minimum requirements, the qualitative requirements for classification in credit rating category A are therefore fulfilled as well. As the quantitative criteria are not applicable and the qualitative criteria are usually met by existing obligations, leasing companies in Germany should be classified in credit rating category A in the SCRA.

But even if receivables from leasing companies assessed in the SCRA are classified in category A, risk weights will be higher than under current CRR, where receivables are assigned a risk weight according to the credit quality step to which exposures to the central government of Germany are assigned. In case of German leasing companies, the assigned risk weight under current CRR is 20%. Even in case of a category A rating in the SCRA the risk weight will be up to two times higher than under the current regime. This massive increase will lead to leasing funding becoming significantly more expensive or being discontinued altogether. The majority of small and medium-sized leasing companies then threaten to be forced out of the market, even though leasing business is much less risky than comparable lending business. This will have massive impact on SME of the real sector and will lower financial stability through forced concentration in the financial sector.

In addition, it must be taken into account that the original credit risk in the leasing business is further reduced by the intermediary position of the leasing company between the lessee and the funding credit institution. This leads to a further risk coverage by the own funds of the leasing company.

<u>While risk weights under the current CRR regime are already too high for the low-risk, less complex business model of small sized leasing companies in Germany, we therefore propose a leasing risk weight in the new SCRA not higher than under the current status. This understanding corresponds to the low risk in leasing in Germany which is empirically proven by the studies of the University of Cologne.</u>

(2) If, on the other hand, leasing companies are directly affected and credit risks have to be backed with regulatory capital in accordance with the CRR, the low risk in leasing compared with lending business should be taken into account by means of specific risk weights in the standardized approach and further adjustments in the advanced approach.

BDL supports the proposal developed by the European Leasing Association, LEASEUROPE, in cooperation with the University of Cologne. The proposal is summarized in Table 2 and explained in detail in LEASEUROPE's comments on this consultation.

a) STANDARDISED APPROACH	
Amend Art. 122 & 123 CRR to include new leasing risk weights	Proposed risk weights for leasing exposures: 50% Retail leasing / 65% Corporate leasing
IRB-FOUNDATION	**IRB-ADVANCED**
b) Add specific haircut for leasing collateral of 20% OR equivalent overcollateralization of 125%	
c) Specific leasing collateral in Art. 230(2) Table 5 CRR: 20% leasing LGD	d) Specific LGD input floors for leasing portfolios (both Corporate & Retail): 10% secured leasing / 20% unsecured leasing

Table 2: Proposal for better recognition of leasing's low risk

Operational Risk

In contrast to the case of credit risk leasing and credit face comparable operational risk, therefore regulatory capital for operational risk should be comparable as well. If leasing income and expenses including depreciation are netted, the aim should be reached. Furthermore, the combination of leasing and credit in one category promotes consistency of treatment.

Therefore, we welcome the Basel III approach for operational risk which counteracts previous inconsistencies in determining regulatory capital in credit and leasing.

Sustainable Finance

The life cycle of a leasing business usually begins with the lessor acquiring the asset desired by the lessee from the manufacturer/dealer. The asset is then made available to the lessee for a contractually agreed basic rental period and a usage fee. At the end of each leasing contract there is the remarketing/exploitation of the asset, which is an integral part of the business model.

The lessor remains the owner of the leased asset for the entire term of the leasing agreement. Therefore, success in leasing depends not only on knowledge of the customer's needs and market conditions, but also on the lessor's expertise in the asset. A holistic view of the entire life cycle of the leased asset is inherent in the "leasing" business model and corresponds to the model of a sustainable recycling economy, in which the aim is to reduce the use of resources through the durable construction, maintenance, repair, reuse and refurbishing of the objects.

Furthermore, leasing is indispensable for the technological change towards a sustainable economy, since the implementation of technical progress is closely linked to leasing as a preferred type of investment and financing. This was exemplified by the introduction of information technology in the 1960s and 1970s, which went hand in hand with the spread of the leasing business model. Since then, the economic significance of leasing has steadily increased.

Leasing will therefore also make a significant contribution to promoting sustainability, e.g. by implementing new mobility concepts and the transition to electromobility. The leasing sector is therefore not only facing up to the challenges posed by climate protection in particular, but is also prepared to make an active contribution and to realise a significant proportion of the necessary investments.

<u>However, this requires a broad and active sector that must not be slowed down by excessive, predominantly bureaucratic duties. Therefore, we widely support the sustainability objective, but rather propose to critically assess the appropriateness of the means on achieving the desired objectives.</u>

We urge you to take our comments into account, as otherwise we expect considerable disadvantages for the financial markets in Germany and Europe, without these disadvantages being offset by appropriate advantages in terms of financial market stability.

If you have any questions or require additional information, please do not hesitate to contact us.

Yours sincerely

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